



Legislative Department Seattle City Council Memorandum

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To: Energy and Technology Committee

From: Carol Butler, Michael Fong
Central Staff

Subject: 2007-2008 City Light Rate Proposal

This memorandum presents (1) an overview and summary of the Executive's 2007-2008 City Light rate proposal (2) a summary of the components, and (3) a tentative list of major issues identified for further review by Council staff with a list of rate review assignments for your reference.

I. OVERVIEW OF THE EXECUTIVE'S PROPOSAL

The Executive proposes a decrease of 4.8% for City Light's average base rate for the 2007-2008 rate period (January 1, 2007 through December 31, 2008). Average rates represent the costs City Light expects to charge customers throughout the areas where City Light provides service. While the average base rate decrease is 4.8%, the average system rate decrease is actually 4.1%. Base rates are rates before specific adjustments for discounts and additional charges (such as power factors and transformer discounts) while system rates include the adjustments.

City Light's proposal, if approved, would establish rates by combining information for the two year period and essentially dividing the results in two. This has the effect of smoothing rate effects and is consistent with the established policy of gradualism. Otherwise, had City Light elected to establish rates independently for each of the two years, City Light would have proposed instead an average base rate decrease of 7.7% in 2007 followed by an increase of 5.8% in 2008.

If approved as proposed, rates for most customer classes will decrease (-) beginning in 2007 but will increase (+) for the residential and small general service customers in suburban contract areas as well as for streetlights. This occurs because City Light proposes to allocate all customers the actual costs of service developed in the utility's study and to charge suburban customers and Tukwila the maximum amount allowed in contracts. Differences in the rates also stem from the method of allocating surplus power sales revenue which provides a greater benefit to those customers that use more energy.

Unlike most other utilities which categorize customers as residential, commercial, government, and industrial City Light uses the categories of residential, small general service, medium general service, and large general service for customers and further divides the categories into separate rate schedules for city, Tukwila, and suburban customers and the city between network and non-network customers. Table 1 shows the differential rate impacts of City Light's proposal by rate class and schedule and resulting changes in revenues.

Table 1
City Light Proposal

Customer Rate Class	Proposed 2007-2008 Rate Change	Millions of Dollars over 2007-2008
Seattle Non-Network:		
Residential	- 2.2%	-\$ 7.4
Sm Gen Service	- 2.3%	-\$ 2.8
Med Gen Service	-13.8%	-\$25.7
Large Gen Service	- 9.0%	-\$ 7.7
High Demand	-11.4%	-\$11.5
Seattle Network:		
Medium General Service	- 6.7%	-\$ 4.5
Large General Service	- 1.8%	-\$ 1.4
Suburban:		
Residential	+ 0.8%	\$ 0.8
Sm Gen Service	+ 0.2%	\$ 0.0
Med Gen Service	- 9.1%	-\$ 2.2
Large Gen Service	- 3.3%	-\$ 0.1
Tukwila:		
Residential	+ 2.8%	\$ 0.2
Sm Gen Service	- 0.9%	-\$ 0.4
Med Gen Service	- 10.2%	-\$ 1.2
Large Gen Service	- 4.3%	-\$ 0.6
High Demand	- 9.9%	-\$ 2.3
Streetlights	+69.3%	\$ 9.9
Average Rate/ Total Savings	- 4.8%	-\$56.9

II. SUMMARY OF THE COMPONENTS

Below you will find information about the components of the 2007-2008 Rate Proposal followed by some additional information on rates. Each electric rate proposal contains three different components: 1. a revenue requirement, 2. a cost of service and cost allocation study, and 3. rate design.

Revenue Requirement. The amount of revenue that City Light estimates will be needed from retail customers to cover operating and maintenance expense and to meet current financial policies is called the revenue requirement.

Cost of Service and Cost Allocation Study. The Cost of Service Study classifies costs into categories such as direct and indirect by function such as generation or distribution. These costs are then allocated to customers to determine the share of the total revenue requirements to be collected from each customer class.

Rate Design Report. A rate design report presents the structure and components (fixed, energy, or capacity) of rates for each customer class. Rate design is guided by principles which may require judgment because compliance with one principle may preclude meeting another. The principles City Light applied in this proposal, for example, include encouraging conservation by use of increasing

blocks for the energy component and sending appropriate signals to customers through the demand charge as an incentive to manage loads. An explanation of each charge can be found in a later section of this paper.

More detail about how each of the three listed components is incorporated into the current City Light proposal follows.

A. Revenue Requirement.

Table 2 shows City Light's proposed revenue requirement for 2007 and for 2008. Major expense categories that must be funded are listed as well as additional revenue sources that help to offset the need for funds from retail customers.

Table 2
Revenue Requirement Summary
(All Dollars in Millions)

	2006	2007	2008
Retail Power Sales	\$566.1	\$551.4	\$563.5
Net Wholesale Revenue	\$137.1	\$178.9	\$140.7
Other Revenue	\$ 39.5	\$ 41.5	\$ 44.8
Less:			
Power O&M	\$276.5	\$281.6	\$268.5
Other O&M	\$155.6	\$164.6	\$167.9
Non-city Taxes	\$ 27.9	\$ 27.7	\$ 28.1
Plus:			
Investment Income	\$ 7.6	\$ 7.1	\$ 4.5
Other Income	\$ 1.1	\$ 9.6	\$ 1.1
Subtotal:			
Revenue Available for Debt Service	\$291.4	\$314.7	\$290.2
Less:			
Debt Service	\$141.7	\$140.9	\$136.9
City Taxes	\$ 34.9	\$ 34.1	\$ 34.8
Other Funds Required	\$ 2.1	(\$ 0.4)	\$ 2.5
Net Revenue Available for Capital	\$112.7	\$140.1	\$115.9
Net Revenue Required for 95% Confidence	\$112.7	\$140.1	\$115.9

In addition to the proposed retail revenue requirement, other factors affect the calculation of revenue requirements. Two of the major factors are financial policies and the capital program.

1. Financial Policies

City Light's proposal will meet financial policy goals set by Council in 2005 and should achieve a Long Term Debt to Capitalization Ratio of 60% before 2010. Furthermore, the financial policies call for rates to be set such that City Light will, with 95% confidence have some revenue available for the capital program. This helps to ensure that the total debt will be reduced over time. Table 3 shows projections of what will happen over the next four years if rates are set to this standard. Note that the debt/capitalization ratio will fall below the 60% target by 2010.

Table 3
Key Financial Indicators
(all dollars in millions)

Indicator	2007	2008	2009	2010
Long Term Debt Outstanding	\$1,342.5	\$1,317.1	\$1,390.0	\$1,469.1
Long Term Debt as a % of Capitalization	67%	63%	61%	59%
First Lien Debt Coverage	2.45	2.26	2.19	2.25
First and Second Lien Debt Coverage	2.31	2.12	2.00	2.00
Net Income *	\$141.1	\$117.3	\$103.3	\$114.8

* City Light assumes a 7% rate of return in the proposal.

2. Capital Improvement Program

Table 4 provides proposed 2007 and 2008 CIP spending in various categories. What isn't apparent from examining this table is that City Light's CIP has already increased by more than \$30 million annually in the last two years.

Table 4
City Light
Proposed Capital Improvement Program
(Thousands of dollars)

	2006	2007	2008	Increase '06 to '08
Generation	22,556	23,290	26,295	3,739
Generator and Turbine Runner Rebuilds	7,591	6,821	12,921	5,330
Boundary Plant Improvements	5,089	3,398	3,867	(1,222)
Skagit Plant Improvements	6,991	9,166	6,019	(972)
Environmental Mitigation	909	818	650	(259)
All Others	1,976	3,087	2,838	862
Transmission	5,369	5,573	3,992	(1,377)
Substations	11,971	7,322	12,441	470
Distribution	86,917	137,957	151,779	64,862
26KV Conversion	328	2,884	4,079	3,751
Sound Transit	13,991	15,469	4,053	(9,938)
Network Additions and Services	19,299	21,621	23,513	4,214
Service Connections	14,236	13,753	13,638	(598)
Capacity Additions	16,717	14,975	14,566	(2,151)
Other Relocations	8,839	5,104	3,154	(5,685)
Alaskan Way Viaduct	1,446	23,726	43,266	41,820
Street and Floodlights	1,596	2,048	1,905	309
Outage Prevention	2,235	3,360	1,757	(478)
Residential Undergrounding	-	1,805	4,882	4,882
Franchise Undergrounding	2,659	2,718	2,342	(317)
Capacity Load Transfers	-	5,253	4,261	4,261
Automated Meter Reading	-	880	1,310	1,310
All Others	10,465	24,361	29,053	18,588
General Plant	19,289	21,590	27,791	8,502
Vehicle Replace and Add	4,273	5,555	7,654	3,381

Security Improvements	1,556	2,159	2,346	790
Communications Improvements	2,069	2,250	2,560	491
Information Technology	9,382	9,205	12,647	3,265
All Others	2,009	2,421	2,584	575
TOTAL ALL PROJECTS	146,102	181,716	207,746	61,644

In addition, Table 4 does not show projected spending of an additional \$200+ million in the following few years for utility relocations associated with replacing the Alaskan Way Viaduct. If approved, City Light's proposal will result in significant impacts to ratepayers in future years.

B. Cost of Service

Six years ago rates were established through a detailed cost of service study. The current proposal builds on that previous work but included some important changes. City Light's proposal for 2007 and 2008 reflects changes not only in the relative cost to serve different customer classes but also two other changes. The first affects customers in Tukwila as a new agreement was signed in 2003 that allows City Light to charge higher rates to these customers. The second affects streetlights and reflects the impact of the state Supreme Court ruling in the Okeson case.

In terms of the overall approach, City Light's cost of service proposal processes the revenue requirements for the two years 2007 and 2008 by adding them together and then allocating the costs to the various customer groups for the two year period.

City Light uses what it terms a marginal cost framework when allocating the costs. Utilities generally use one of two methods of determining how costs are developed and allocated. One uses average historical costs (an embedded cost study) and the other projected incremental costs (a marginal cost study).

An average embedded cost of service study is based on accounting records and costs that have been booked. It is widely used because actual costs can be easily determined but these costs may not capture future changes in operations or policy.

A marginal cost of service study reflects the incremental changes in costs to provide service as projected into the future. However while a marginal cost study may promote economic efficiency it needs to be adjusted to meet a revenue requirement.

An example of the differences in each method is shown below.

Assume some utility generates or purchases 2,000,000 MWh of electricity a year with 75% coming from coal fired generation and the rest from more expensive nuclear. In addition, the utility needs another \$38 million to pay for other operating and maintenance expense. Then the costs and revenues would be determined as follows:

1.5 Million MWh from coal @ \$40/MWh=	\$ 60 million
.5 Million MWh from nuclear @ \$80/MWh=	<u>\$ 40 million</u>
Power Costs=	\$100 million
Other Costs=	\$ 78 million
Total Costs=Total Revenue=	\$176 million
Average Embedded Cost (\$176 million/2,000,000MWh) =	<u>\$88/MWh</u>

Last Unit Generation Cost (nuclear) =	\$ 80/MWh
Other Cost (\$78 million/ 2,000,000 MWh) =	<u>\$ 38/MWh</u>

Marginal Cost=

\$118/MWh

Marginal Total Revenue= (\$118/MWh x 2,000,000)

\$236 million

If circumstances were expected to change, the total revenue of \$176 million would not provide sufficient revenue to pay for operations. On the other hand, the \$236 million would need to be scaled down to collect the actual revenue required to pay for operations.

In this proposal City Light determines rates using a hybrid methodology that allocates revenue requirements based on marginal cost shares. This would mean. For example, that for the amounts listed above, the generation cost and other costs would be separately allocated based on what percentage a customer contributed to the total cost of that component rather than the actual marginal cost to serve that customer.

Because City Light proposes an overall decrease in rates, in this Cost of Service Study, City Light proposes that costs be paid by all classes with no adjustments.

C. Rate Design

In general, each rate could consist of a fixed charge, an energy charge, and a demand charge with a summary explanation of each found below. However, not all rates proposed by City Light contain each of the three. Rates for residential and small business general service customers do not contain a demand charge (which reflects impacts on peak usage rather than overall energy consumption) because due to the significant expense that would need to be incurred.

Fixed Charge

Fixed charges do not change with the amount of energy or the demand on the system. They recover costs for customer accounting, meter reading, and other similar expenses. City Light proposes to increase Small General Service and Large General Service charges starting in 2007 and adds a new charge for Medium General Service rates at an unknown time during the next two years.

Demand Charge

Demand charges reflect impacts on the capacity of the system to provide service. Beginning in 2007, City Light proposes to increase this charge for Large General Service and High Demand Customers during both On and Off Peak hours.

Energy Charge

Energy charges capture the costs of providing the actual power used by each customer. These charges were developed using a short-term forecast of the West Coast market energy prices. The values City Light computed turn out to be higher and flatter across the months of the year than those used in the last rate review in 1999. Because of this relative flatness, City Light proposes rates with year-round energy charges rather than with seasonal differentiation. City Light also proposes a design that moves toward the marginal value of energy. A shift away from seasonal charges represents a significant policy change and was first implemented during the Western Energy Crisis. Seasonal variations in the marginal cost of power have been significantly reduced due to the impacts of competitive power markets.

In addition to revisions in the three rate components, City Light proposes to eliminate the Variable, New Large Load, and Interruptible rates and to add new charges for Pedestrian Lights and a new rate schedule for Small General Service customers located on the Downtown Network starting in 2007. Pole Attachment rates will also increase.

III. MAJOR ISSUES (TENTATIVE)

This list of issues for further Council staff review was developed from examination of the Executive's proposal to date. Some issues may be removed after staff questions are addresses and others may be added as the review moves forward.

Even though many of the issues listed appear to be mainly technical and would require technical revisions, many of decisions could have important policy implications as well.

Issue 1: Should rates be approved for a two year period or should rates be put in place for one year? (Carol Butler)

City Light's proposal covers the two year period 2007 and 2008. City Light's proposal smoothes the rate trajectory by essentially averaging revenue requirements over the two years.

However, it would also be possible to adopt rates for 2007 only. This would allow the Council to review financial policies independently of a rate review. When adopting financial policies in 2005, Council noted that a financial policy review would occur when City Light reached a long term debt to capitalization ratio of 70%. This will certainly be achieved by sometime in 2007 and might be reached before the end of 2006. City Light has largely achieved the financial goals that was the goal of the very conservative financial policies that were established during the energy crisis and re-affirmed in 2005 with some adjustments. With these polices in place, City Light has large cash balances on hand and has been able fully to fund its capital program since 2004. The recent upgrade in City Light's bond rating to A+ by Standard and Poor's is indicative, as well, of the success of the policies. Therefore, it could be appropriate to review all of the financial policies to determine whether the policies need to be rebalanced before approving rates for 2008. But in any case, a review of financial policies is likely in the near term, certainly no later than in 2007.

Issue 2: Should the proposed 7% return on equity be altered?

In past rate proposals City Light has traditionally included a "rate of return" on equity as a way to ensure that there would be a cash contribution to the CIP. In this proposal City Light has lowered the return percentage from a previous 10% to 7%, but it still add approximately \$100 million to the allocation of revenue requirements over the two years.

Since the existing financial policies are structured to ensure that there is revenue available for the capital program with 95% confidence, it appears that in a very real sense City Light might be "double counting". This might be characterized as a "belt and suspenders" approach. No matter what the characterization, this seems worthy of further review.

Table 5
City Light Rate Proposal
Rate of Return
Net Income (Millions of dollars)

	2007	2008	Proposal Total
Financial Policy	\$ 91.2	\$ 67.4	\$158.5
Equity Contribution	\$ 53.6	\$ 46.4	\$ 99.9
Allocation Amount	\$144.8	\$113.8	\$258.6

Because of the impact on revenue requirement allocation, further review of the rate of return on equity is warranted.

Issue 3: Should the methodology used to determine surplus energy sales be revised? (Carol Butler)

As stated above, in 2005 the Council approved a conservative financial policy of using a 95% confidence of having sufficient revenue to fund the capital program. In addition to this financial policy, City Light estimates its resource needs using a 95% confidence of having sufficient resources on a monthly basis and purchases additional power when it appears based on modeling runs that this target will not be met on a monthly basis.

In this proposal, City Light calculates revenue requirements using an even more conservative assumption that increases revenue requirements above what the 95% policy as adopted by the Council would produce. Whether or not this additional conservatism is justified will require further investigation.

Issue 4: Should O&M expenditures be modified? (Carol Butler)

There are several areas where proposed administrative and general expense can be questioned. For example, it is not entirely clear whether projected labor costs and tree trimming increases for 2007 and 2008 can be fully justified. Some preliminary information about each of these expenses follows below.

As of June 30th, City Light has 183 vacant positions though the utility indicates that about 103 are in the process of being filled. From a preliminary examination, it appears that the number of vacant positions at City Light has continued to increase over the last three years. Since the number of vacancies does not seem to be falling but actually seems to be rising and City Light assumes zero vacancies when calculating its revenue requirements, the labor cost increase in 2007 and 2008 revenue requirements should be analyzed further.

City Light proposes to more than double the spending on tree trimming in each of the next two years despite the fact that budgets have already doubled over the last couple of years. Actual spending, though, has not kept pace with budgeted amounts. Examination of outage patterns and impacts on reliability will help to determine whether the proposed level of spending should be approved.

Issue 5: Should the proposed capital improvement program expenditures be approved as proposed? (Carol Butler)

City Light proposes to spend an additional \$62 million more on the Capital Improvement Program (CIP), not including conservation and mitigation, in the next two years. There are two questions that might need to be answered before making a determination about the CIP: 1) should Council approve a program of this size before an asset management program has been implemented and results are known and 2) can City Light accomplish the proposed level of activity?

Issue 6: Should City Light's cost of service methodology be adopted as proposed? (Carol Butler)

Resolution 30685 adopted in 2004 established long term rate setting objectives and electric rate policies. In the resolution, Council stated that City Light was to submit a marginal cost study and an embedded cost study. City Light submitted a cost study with this proposal that is based on what City Light calls a marginal cost framework but that is actually a hybrid methodology.

City Light use of the marginal cost framework in the 2007 and 2008 proposal also differs in some respects from the methodology used in the last comprehensive rate review. City Light's proposal, for example, allocates costs by 10 functional areas for non-network classes and network separately. In 1999, however, marginal cost shares were computed assuming all classes were non-network using only 4 functional shares.

Further, City Light developed streetlight costs outside the cost of service. This methodology results in proposed streetlight rate increases of over 69% during the two year period.

A review of alternatives should provide relevant information about impacts on different customer classes both from the methodology not used and from the revisions proposed by City Light. Council has engaged an outside consulting firm, EES Consulting, of Kirkland to assist with this effort.

Issue 7: Should the cost allocations be revised? (Carol Butler)

The cost of service model City Light used to determine the costs to be allocated to each customer class necessarily involves judgment about which cost categories to use and what method is employed to determine which classes should pay what proportion of costs.

The analyses used in the current proposal, if approved, will reflect changes in circumstances facing the utility and changes in public policy. These include the effects of a Supreme Court Decision on streetlights and a new contract with Tukwila. They also include a decision to alter the method of allocating surplus sales revenues.

Obviously, these differences as well as others that have not been cited will affect the costs that have been allocated to various customers classes. Further examination of the allocations should provide more information about whether any of the costs should be allocated differently.

Issue 8: Should customers located in the First Hill and University District areas pay network rates? (Michael Fong)

City Light's network service areas are in Downtown, First Hill and the University District.

Customers in these service areas experience greater system reliability, but at a higher service cost to the utility. City Light proposes to recoup 100% of those costs through network service rates for medium and large customers in the Downtown Network. At this time no network rates are proposed for the First Hill or University District service areas.

City Light proposes to examine issues related to the First Hill and University District networks prior to making a rate recommendation to Council next year. Council may want to accelerate this review on the basis of City Light's proposal to recoup the full cost of service differential from Downtown Network customers. Alternatively, Council may want to delay implementation of any changes to the Downtown Network rates (see the next issue) until a comprehensive policy review can be conducted of all network service areas.

Issue 9: Should residential and small business general service customers located in the downtown network pay network rates? (Michael Fong)

Currently medium and large general service customers pay 50% of City Light's actual cost differential for providing service in the downtown network. City Light proposes to establish rates that recover the full 100% cost differential beginning in 2007.

Though the new network rates would apply only to medium and large general service customers, the Downtown Network consists of an underground distribution system that provides electricity to customers north of King St. and Jackson St., south of Denny, east of Elliott Bay and west of Interstate 5. While they do not pay network rates, this area includes City Light customers that fall into the residential and small business general service classes. Currently it is assumed that they don't really benefit, that the network was installed for the sake of the larger customers, and that smaller customers would just as soon be served by standard service so they should not pay the higher network rate. Council may want to examine the basis for the underlying policy rationale.

Issue 10: Should the low income rate reduction from standard rates remain at 40% or gradually be raised to 50%? (Michael Fong)

During the “energy crisis” in 2001, the Council and Executive held low-income customers harmless from some of the rate increases. Consequently, the spread between what residential customers and customers in the rate assistance program pay has grown. In 1989, Council approved Resolution 28004 establishing a policy for setting low-income rates at 50% of rates paid by other residential customers. However, the current discounted rates are roughly 40% of the standard residential rate.

City Light proposes to maintain the current rate differential between residential and low-income customers. Under the current rate proposal, City Light estimates that the average rate assistance customer will see about a 1.5% reduction in their annual bill. An analysis of the billing impact to low income customers might provide information for a decision about whether the 50% policy should be restored.

Issue 11: Should the third tier in residential rates be eliminated? (Carol Butler)

Since 1980 City Light has had a residential rate structure whereby customers are billed at a low rate for the first portion (first block) of energy consumption and at a higher rate for consumption in excess of that amount (second block). During the Western Energy Crisis a third block was added to send a price signal to customers to conserve.

City Light proposes to leave the third tier in residential rates and, furthermore, not to change the price per kWh. In 2004 City Light noted that there were less than 800 customers out of more than 370,000 residential customers who actually paid charges in this rate block. With the price differential of only about 1.4 cents per kWh, it appears that the third block could be eliminated without adversely affecting either conservation or revenue requirements. Examination of the effects of eliminating the third block should provide additional information useful in making a decision.

Issue 12: Should rates be restructured to reflect impacts on capacity needs from new loads? (Carol Butler)

Over the past few years during discussions relating to development of a transmission and distribution capacity plan, City Light made it clear that many customers were requesting service at capacity levels above those that City Light’s engineering estimates predicted would be used, leading to expenditures for installation of capacity that was not used. In addition, some customers have been requesting that City Light reserve a portion of a separate distribution feeder to carry their load when normal service is not available.

As a separate, but related issue, developers in South Lake Union have also requested that City Light consider building a network in South Lake Union which would cost significantly more than standard overhead service because of the redundant capacity that would need to be installed. This might result in the need to construct a substation that might not otherwise be needed or to move the construction date forward ten or more years.

None of these issues have been addressed in City Light’s 2007-2008 rate proposal and will mean that other ratepayers could end up paying for costs that will effectively subsidize the installation of additional capacity not needed to serve their loads. A review of the costs and benefits of potential additional charges should assist in making a decision on whether such charges should be imposed and, if so, in what form.

Issue 13: Should the minimum monthly (fixed) charge be revised? (Carol Butler)

City Light's 2007 and 2008 rate proposal establishes the minimum daily charge to be paid by customers in each rate class using different methods. As a result, if approved, minimum charges would change as shown in the table below.

Table 6
City Light Rate Proposal
Minimum Daily Charge

Rate Class	Percentage Change from 2006
Residential	0%
Residential Low Income	0%
Small General Service	15%
Medium General Service	New Charge
Large General Service	177%
Large General Service Network	170%
High Demand Service	-2.6%

Nevertheless, the minimum daily customer charge does not cover the costs incurred by City Light for reading meters, customer billing, and other overhead. Since Council policy, as articulated in Resolution 30685, clearly states that rates should be based on the cost of service, revising the proposed rate structure could help to meet this goal. Analysis of potential impacts should provide data relevant to determining whether further movement towards full cost should be made in 2007 and 2008.

Issue 14: Should an interruptible rate be offered? (Carol Butler)

City Light proposes to eliminate its interruptible rate beginning January 1, 2007. Currently only 1 customer takes advantage of the rate. However, many customers who attended City Light's public rate forums thought that City Light should instead explore expanding interruptible rate offerings to include more customers. These customers seemed to understand that any such rate would have to provide benefits to both City Light and participating customers.

Resolution 30685 makes it clear that any such rate must be based on the cost of service and that other customers must not subsidize any customer receiving an interruptible rate. Setting specific criteria for an interruptible rate could serve to ensure that customers wishing to take advantage of such a rate have access to it and that City Light will be made whole. This should provide important information to allow a policy decision to be made regarding the appropriateness of continuing to offer an interruptible rate to be made available some time next year.